



Minutes of the Advisory Panel to DEFAC
Buena Vista Conference Center New Castle, DE – March 2, 2018

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| Attendance: | Chairperson, Mr. Michael Houghton | | | P |
| K. Lewis | P | H. McDowell | | A |
| E. Ratledge | P | Q. Johnson | | P |
| K. Simpler | P | M. Ramone | | A |
| J. Bullock | A | A. DelCollo | | P |
| R. Geisenberger | P | R. Johnson | | P |
| M. Jackson | P | S. Malfitano | | P |
| M. Morton | P | D. Smits | | P |

Support and Staff Present:

A. Loiaconi, A. Aka, R. Goldsmith, J. Johnstone, N. Roby, D. Roose, S. Bailey, A. Jenkins, B. Scoglietti, S. Scola, D. Burris, S. Steward

Members of the Public:

1. Introduction & Prior Meeting Minutes

Chairman Houghton called the meeting to order.

Chairman Houghton summarized the past three meetings and the reasoning for the gap since the prior meeting. Chairman Houghton reiterated the need for a substantive and useful recommendation, and that this work was primarily being done by the Department of Finance and the Office of the State Treasurer. To refresh the Panel, Chairman Houghton recapped the questions surrounding the creation of a Budget Stabilization Fund including the size, rules for deposit and withdrawal, and the use of such a fund. Chairman Houghton summarized the discussion surrounding the tax base and the volatile nature of the base. With several questions remaining unanswered and work left to be done, Chairman Houghton reminded the Panel that a preliminary report is due in May.

In response to Chairman Houghton's remarks, Treasurer Simpler added that the purpose is to create better sustainability for both revenues and expenditures. Secretary Geisenberger reiterated the structural spending and revenue problem that the State faces each year and noted that the solution adopted last year actually increased volatility by adding realty transfer tax increases.

Chairman Houghton called for a motion to approve the minutes from the December and November meetings. Motion approved unanimously.

2. Follow-up From Prior Meeting

During the prior meeting, there were some general questions related to budget stabilization funds and reserve accounts. In order to maximize meeting time, responses were passed out to the Committee.

3. Delaware Simulations – Revenue Policy

Mr. Johnstone presented on the proposed revenue portfolio changes initially considered in the 2015 DEFAC Advisory Panel on Revenue report. Summarizing the 2015 report, Mr. Johnstone reiterated Delaware's reliance on "silver bullets" such as the bank franchise tax, lottery revenues, and abandoned property to make up shortfalls. The report expressed concern about the reliance on volatile, outsourced revenues.

Mr. Johnstone presented data on the prior 30 years of state revenues. In 1990, the bank franchise tax, lottery, and abandoned property accounted for 9.7 percent of general fund revenues. Mr. Johnstone reported that by 2005, the share of these three combined accounted for 21.6 percent of the State's total revenues, and in 2010 they peaked at 25 percent. They have come down to about 15 percent of revenues today, with little prospect for significant growth as there is a cap on abandoned property revenue, lottery revenues are flat, and the bank franchise tax is likely to decline.

Mr. Johnstone discussed the State's revenue portfolio compared to the national average, and noted that while some other states have state property taxes, the reliance on property tax in Delaware is quite low. Treasurer Simpler queried if the State were to replace a specific share of its revenue with a statewide property tax, what impact would that have on current rates. Mr. Jackson stated that the impact would be minimal. Mr. Jackson commented that the level to be replaced should be based on the expenses funded by the State that should be funded at the local level, similar to a proposal from prior years. Mr. Jackson reminded the Panel that in most states property taxes fund closer to 60 to 70 percent of local expenses, whereas Delaware is the opposite, funding the majority of education expenses at the State level.

Finally, Mr. Johnstone discussed the recommendation of base broadening to the personal income tax made by the 2015 Advisory Panel on Revenues. Mr. Johnstone stated that having a narrow base and a high rate would result in less stable revenues, whereas a wider base with a lower rate would result in a more stable revenue source. Specifically, the State's personal income tax has several factors that narrow the tax base, including itemized deductions and age-based tax preferences. Mr. Johnstone presented a few ideas from the 2015 report such as eliminating itemization and means-testing or capping age-based tax preferences. To make these changes revenue neutral, the State could choose to raise the standard deduction or lower tax rates as was suggested in 2015.

Mr. Johnstone summarized Delaware's three current age-based tax preferences, including the exclusion of up to \$12,500 of retirement income at age 60 and the additional \$2,500 standard deduction and \$110 personal exemption for persons at age 65. He explained that Delaware laws have broadly defined retirement income to also include interest, dividend and even rental income. Chairman Houghton

asked over what the period of time these tax preferences have accumulated. Mr. Johnstone responded that many of these tax preferences have come about since the 1990s, and throughout the last decade. Chairman Houghton pointed out that these came about during the period in which Delaware had significant revenue gains. Mr. Johnstone reiterated that the State does not tax social security income at all, despite the Federal government taxing a significant portion. Chairman Houghton asked if the State's tax preferential treatment of retirement income was better than that of neighboring states. Secretary Geisenberger stated that it varies by state. For example, in Pennsylvania pension income is not taxed at retirement; however, unlike Delaware, Pennsylvania does not permit employees to deduct pension and other retirement savings contributions. Mr. Malfitano stated that persons at age 65 years old from other states would have great incentives to retire in Sussex County with very low property taxes and favorable treatment of income. Mr. Malfitano asked how many individuals 60 and over have moved to the State over the past ten years. Mr. Ratledge stated that he didn't have it on hand, but concurred that it is significant.

Mr. Johnstone stated that means-testing retirement income would likely add about \$30 million to personal income tax revenues by fiscal year 2020. Furthermore, Mr. Johnstone stated that making the eligibility age a uniform 65 for age-related tax preferences, the State could anticipate revenue increases of approximately \$4 million from the reduction in personal credits and \$18.5 million as a result of the change from the retirement exclusion by fiscal year 2020. This would grow slightly over time as more people reached these ages and could be phased in. Mr. Johnstone stated that with the elimination of itemization and means testing of age-based exclusions that the State could get to a revenue neutral proposal by reducing the top marginal rate from 6.6 percent to just below 6 percent. In the out years, revenue collections would increase as the State is increasing the potential taxable income base by approximately 11 percent. By fiscal year 2022 this would potentially generate an additional \$88.5 million.

4. Delaware Simulations - Rainy Day Funds & Stabilization Accounts)

Susan Steward, Policy Advisor for the Office of the State Treasurer, summarized the current Budget Reserve Account (BRA) for the State. Budget Reserve Accounts, or "Rainy Day Funds," often seek to accomplish three objectives: 1) manage revenue shortfalls, 2) provide liquidity in years of economic downturns, and 3) address one-time emergencies. Only four states do not have some form a Budget Reserve Account (BRA) or Budget Stabilization Fund. Ms. Steward reviewed the purpose of Delaware's fund, commenting that the ambiguous purpose of the fund has perhaps contributed to the non-use of the fund since inception. Ms. Steward reviewed the current constitutional framework of the BRA, which requires that it be no more than 5 percent of General Fund revenues, and that withdrawal from the fund requires a 3/5 majority vote. Furthermore, an appropriation can only be made from the BRA in the case of an emergency or to offset a revenue reduction as a result of legislation. The State's BRA has no repayment mechanism outside of ensuring that the balance is at 5 percent of General Fund revenues.

Ms. Steward reviewed the balance of the BRA going back to the early 1990s, reiterating that it remained at a constant five percent of General Fund revenues except during the Great Recession, when no

deposits were made as revenues fell below prior years' and the fund exceeded the five percent requirement. Ms. Steward reiterated that since the only mechanism to withdraw from the BRA is the 3/5 majority vote, it was not drawn down and no deposit was required to meet the five percent threshold again until fiscal year 2012.

When reviewing all of the AAA-rated states, Delaware was one of three states not to use its budget reserve account and is the only state not to have used its account since inception. Between 2000 and 2017, seven of AAA-rated states have drawn down their reserve funds to one percent or less, which has rarely resulted in losing a AAA-rating. The only state that received a downgrade was North Carolina, but the reasons stated for the downgrade were a conglomeration of poor fiscal management and legal judgments, and not as a result of using its reserve fund. Ms. Steward noted that Indiana received an upgrade to a AAA-rating in a year it withdrew from its reserve fund to supplement the budget during the recession.

Ms. Steward stated that OST requested that the State's financial advisor, PFM, review the value-added of the AAA-rating in terms of cost of issuance with respect to the most recent bond sale. At the time, PFM estimated that the value-added was a reduction in present value costs of issuance by approximately \$2.8 to \$3.7 million over the life of the bond. Treasurer Simpler reiterated that if the State were downgraded this would add approximately \$200,000 to debt service annually for each bond sale. When viewing this savings in perspective of the shortfall during the Great Recession, which was about 20 to 25 percent of General Fund revenues in 2009, the savings is minor. Finally, Treasurer Simpler noted that often the fund is considered a credit enhancement mechanism that lowers borrowings costs. However, the savings over the 20-year life of one bond issuance saves the State a total of approximately \$4 million.

Ms. Steward reiterated that the use of the BRA is not the only available mechanism by which the State can manage deficits. The State can issue Revenue Anticipation Notes (RANS), or use inter-fund borrowing to meet short-term deficits. Ms. Steward reviewed the State's investment portfolio, reiterating that the \$231.6 million BRA balance is not the only funds the State has available. In fact, the State's investment portfolio is approximately \$1.7 billion, and since 2006 the portfolio has averaged approximately \$1.4 to \$2.0 billion in investments. Finally, Ms. Steward recapped that the BRA is held in a short-duration reserve with highly liquid assets which has yielded a three-year return of 1.13 percent. However, if the fund were treated as a reserve that is never touched and thus treated as something akin to a State endowment account, the return could have been as high as 7.44 percent over the same period.

Chairman Houghton queried if the funds have been invested in this manner because it has been assumed that the funds would be used, although this is not the case. Treasurer Simpler stated that if there was a true liquidity crisis, then the State has ample liquidity to meet the needs. Furthermore, the use of the BRA as a credit-enhancement tool does have a real cost associated with it, which is demonstrated by the tradeoff in investment returns. Chairman Houghton asked Treasurer Simpler if he is proposing that the State change how they use the fund or the method by which it is invested.

Treasurer Simpler stated that this is a conversation for the group, and that the group would need to determine the overall purpose of the fund. Furthermore, if the Panel decided that the BRA should remain separate from the Budget Stabilization Fund then the opportunity cost associated with the method of management would require review.

Stephen Bailey, Senior Associate from the Pew Charitable Trusts, summarized Pew's research on states with Stabilization Funds and fund sizing. Mr. Bailey stated that the goal of Budget Stabilization Funds are to smooth out the fluctuations in revenues and expenditures over time, and not to address structural issues. Ultimately, these funds are meant to be built up during periods of revenue surpluses and drawn upon during economic downturns. Mr. Bailey stated that the funds are meant to be used, and if you are going to spend the money it's more a question of when to spend the funds. Total tax revenue fluctuations are volatile during economic cycles, and the goal of budget stabilization funds is to smooth out the volatility associated with economic cycles to provide a more consistent budget line.

Mr. Bailey summarized how states choose to fund their Budget Stabilization Funds, whether through revenue surplus or the use of a formula. The deposit rules vary, with some states choosing to deposit only when revenues exceed forecasts, others requiring a fixed amount, and others tying the deposit to a formula including an economic indicator such as personal income. Mr. Bailey discussed the size of fund that a state should consider. The historical five percent rule of the 1970s has been revamped, with rating agencies looking favorably on states that have reserves equal to about 8 percent of revenues or higher. Moody's has provided a stress test of the states, based on an analysis similar to Minnesota's. In this case, the model looks at how much the State would need to save to mitigate a severe or moderate recession.

Mr. Bailey reviewed the State's BRA and cash balance. Using the Minnesota model as a base, Pew reviewed what percentage of General Fund revenues would need to be saved to meet 50, 80, 90, and 95 percent of recessions for the State. Overall, Mr. Bailey stated that the state would need a fund size of approximately 14 percent to guard against 98 percent of all possible recessions.

Finally, Mr. Bailey discussed what other states have done with their funds such as setting minimum thresholds or altering their ability to draw funds below a threshold requiring a legislative vote. Mr. Bailey stated that some states use "if/then" clauses for when they can withdraw, such as if revenues fall 1 percent then the state can draw upon the fund. Finally, Mr. Bailey addressed the topic of setting limits on what can be drawn from the fund in a given year. In recessions, it may not be ideal to solely use reserves to address budget shortfalls, as such use may unintentionally cover up structural problems. For example, S&P has suggested that if there is a shortfall, states should consider using reserves to mitigate only half of the total shortfall, and use other fiscal mechanisms such as cutting expenditures or raising taxes to resolve the other half of the problem.

5. Open Discussion

Chairman Houghton suggested that there be an additional meeting to move towards a set of recommendations for the preliminary report. The date of March 23rd was proposed for an additional

meeting, and Chairman Houghton requested that Department of Finance and the Office of the State Treasurer work together to build a set of recommendations for the fund and revenue reform.

Chairman Houghton opened the floor to discuss the topic of fiscal controls. Secretary Geisenberger stated that there had been several proposals received to date, and that a review of these proposals should include members from the Office of Management and Budget, Controller General's Office, Office of the State Treasurer, and the Department of Finance. Chairman Houghton stated that his preference would be that the group come to a consensus recommendation to be put forth at the next meeting. There was discussion about the potential fund size, as based upon Pew's presentation. Chairman Houghton asked for consideration of using the BRA to provide the base of the Budget Stabilization Fund that would grow over time. Furthermore, Chairman Houghton recommended that there be some consideration for a body that will review the mechanism regularly to determine the efficacy and functionality over time.

6. Public Comment

No public comment was made during this meeting.

7. Adjournment